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# The 2008 Bankruptcy of Literacy - A Legal Analysis of the Subprime Mortgage Fiasco

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# THE 2008 BANKRUPTCY OF LITERACY— A LEGAL ANALYSIS OF THE SUBPRIME MORTGAGE FIASCO

*Bernhard Grossfeld and Hansjoerg Heppe\**

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*"If you take your neighbor's cloak as pledge, you shall return it to him before sunset, for this cloak of his is the only covering he has for his body."<sup>1</sup>*

## I. INTRODUCTION

WRITING makes lawyers, as the general opinion goes. That is why a number of law schools design their programs to push students into writing early. Beginning in the first semester, they are trained to prepare briefs, office memoranda, and letters to cli-

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1. *Exodus* 22:26.

ents.<sup>2</sup> Legal writing has become the new legal rhetoric.<sup>3</sup> This, however, comes as a surprise to those who believe that lawyers should know about the law before writing on it.<sup>4</sup> It also does not fit well with St. Paul's remark, that "the letter kills,"<sup>5</sup> and is even more troublesome for those who think that law is more than "words, words, words."<sup>6</sup> We believe that lawyers should know the facts they are writing about.<sup>7</sup> The Latin rule "*Da mihi facta, dabo tibi ius*" ("Give me the facts, I will give you the law"), probably expresses best what it means to be "thinking like a lawyer,"<sup>8</sup> if there is such a thing as legal reasoning beyond drawing smart conclusions.<sup>9</sup> But today, law appears to be a realm of words and—in particular—of letters.<sup>10</sup>

#### A. LITERAL FORMALISM

Turning to literal formalism,<sup>11</sup> lawyers gave up their competence for economics and accepted the view that economic analysis of law should reign supreme (i.e., that law should be governed by the wisdom of the markets). This idea claimed to be "in a symbiotic relation with real world

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2. For a good reason, as the Multistate Performance Test that is administered by many U.S. jurisdictions in connection with their state bar examination tests a candidate's writing skills by focusing on questions covering legal analysis, fact analysis, problem solving, resolution of ethical dilemmas, organization, and management of a lawyering task and communication.
  3. See Teresa Godwin Phelps, *The New Legal Rhetoric*, 40 Sw. L.J. 1089 (1986).
  4. Marcus Porcius Cato Censorius (Cato Major) already noted around 200 B.C.: "Rem tene, verba sequantur" ("If you are in control of the subject matter the words will follow"). Latin Quotes & Phrases—Q & R, [http://www.yuni.com/library/latin\\_6.html](http://www.yuni.com/library/latin_6.html) (last visited June 26, 2009). For a more recent example, see Stephen B. Cohen, *Words! Words! Words!: Teaching the Language of Tax*, 55 J. LEGAL EDUC. 600 (2005).
  5. 2 *Corinthians* 3:6. "For the letter kills, but the Spirit gives life."
  6. WILLIAM SHAKESPEARE, *HAMLET* act 2, sc. 2, line 192.
  7. See generally William Twining, *Taking Facts Seriously—Again*, 55 J. LEGAL EDUC. 360 (2005).
  8. Academic Dictionaries & Encyclopedias: *Hodie mihi, cras tibi*, [http://dic.academic.ru/dic.nsf/latin\\_proverbs/1002/Hodie](http://dic.academic.ru/dic.nsf/latin_proverbs/1002/Hodie) (last visited June 26, 2009). Cf. Danny Priel, *Thinking Like a Lawyer*, 57 J. LEGAL EDUC. 579 (2007) (reviewing Lloyd L. Weinreb, *Legal Reason: The Use of Analogy in Legal Argument* (2005)); J. Harvie Wilkinson III, *The Role of Reason in the Rule of Law*, 56 U. CHI. L. REV. 779 (1989).
  9. Priel, *supra* note 8. Cf. Larry Alexander, *The Banality of Legal Reasoning*, 73 NOTRE DAME L. REV. 517, 517 (1998) ("Thinking like a lawyer is just ordinary forms of thinking clearly and well."). See also Joseph Raz, *ETHICS IN THE PUBLIC DOMAIN: ESSAY IN THE MORALITY OF LAW AND POLITICS* 238 (rev. ed. Oxford 1994).
  10. Cf. Cohen, *supra* note 4; David Dyzenhaus, *Nicola Lacey's A Life of HLA Hart: The Nightmare and the Noble Dream*, 55 J. LEGAL EDUC. 606, (2005) (book review). See generally Robert A. Pascal, *A Summary Reflection on Legal Education*, 69 LA. L. REV. 125 (2008).
  11. See JEAN STEFANIC & RICHARD DELGADO, *HOW LAWYERS LOSE THEIR WAY: A PROFESSION FAILS ITS CREATIVE MINDS* (2005). See also Milton C. Regan, Jr., *Jean Stefanic and Richard Delgado, How Lawyers Lose Their Way: A Profession Fails Its Creative Minds*, 55 J. LEGAL EDUC. 454 (2005) (book review).

transactions.”<sup>12</sup> and has spread around the world<sup>13</sup> largely due to its “intellectual fit.”<sup>14</sup> Imposing its particular vision of the world as the only valid one, the idea became a scientific ‘prison’, leading to self-deceptive rationalizations. We became “captives of formalism.”<sup>15</sup> This development was often criticized,<sup>16</sup> but so far without much success.<sup>17</sup> The enticing ideology of perfect markets has continued to hold the supreme position.

Economic analysis of law took possession of corporate law like a ‘revolution.’ It swept aside the valuable lessons from the book “The Modern Corporation and Private Property,”<sup>18</sup> by Adolf Augustus Berle and Gardiner Coit Means, and replaced them with “the confident belief that markets could self-regulate.”<sup>19</sup> Competition for incorporation revenues was hailed as the “genius of American corporate law,”<sup>20</sup> reaching a climax beyond which no further development seemed to be possible—“The End of History for Corporate Law.”<sup>21</sup>

### B. ECONOMIC REALITY

But then reality caught up as we experienced Enron,<sup>22</sup> WorldCom,<sup>23</sup> and the ‘counter-revolution’ of the Sarbanes-Oxley Act of 2002. Yet, today we are suffering from the fall-out of the subprime mortgage bubble burst. On September 17, 2008, Lehman Brothers Holdings, Inc. collapsed

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12. Roberta Romano, *After the Revolution in Corporate Law*, 55 J. LEGAL EDUC. 342, 348 (2005).
  13. Cf. Florian Faust, *Comparative Law and the Economic Analysis of Law*, in THE OXFORD HANDBOOK OF COMPARATIVE LAW 837 (Mathias Reimann & Reinhard Zimmermann eds., 2006).
  14. Romano, *supra* note 12, at 351.
  15. Regan, *supra* note 11, at 454-455.
  16. James Boyd White, *Law, Economics, and Torture*, L. QUADRANGLE NOTES, Summer 2008, at 98, 101. (arguing with Richard A. Posner, *Pragmatism Versus Purposivism in First Amendment Analysis*, 54 STAN. L. REV. 737, 739 (2002)).
  17. Cf. *Basic Inc. v. Levinson*, 485 U.S. 224 (1988).
  18. ADOLF AUGUSTUS BERLE & GARDINER COIT MEANS, *THE MODERN CORPORATION AND PRIVATE PROPERTY* (1968).
  19. Richard Parker, *The Crisis Last Time*, N.Y. TIMES, Nov. 7, 2008, at 55, available at <http://www.nytimes.com/2008/11/09/books/review/Parker-t.html>.
  20. Cf. ROBERTA ROMANO, *THE GENIUS OF AMERICAN CORPORATE LAW* 149 (2003); ROBERTA ROMANO, *The State Competition Debate in Corporate Law*, FOUNDATIONS OF CORPORATE LAW 87 (Roberta Romano ed., 1993); Romano, *supra* note 12, at 348.
  21. Henry Hansmann & Reiner Kraakman, *The End of History for Corporate Law*, 89 GEO. L.J. 439 (2001); See also Sebastian Mock, *Review Essay—Perspectives of Regulatory Competition in European Company Law*, 6 GERMAN L.J. 741, 771-792 (2005).
  22. See generally CORPORATE GOVERNANCE POST-ENRON: COMPARATIVE AND INTERNATIONAL PERSPECTIVES (Joseph J. Norton, Jonathan Rickford & Jan Kleineman eds., 2006).
  23. Cf. Thomas Zaccaro, Jesse Weiss, & Michelle Reed, *Due Diligence Standards for Underwriters After WorldCom*, 13 CORP. GOVERNANCE ADVISOR, No. 2 at 1 (2005).

with assets overvalued by more than US\$ 30 billion.<sup>24</sup> On October 3, 2008, “the U.S. stock market[s] lost roughly \$1.5 trillion in value.”<sup>25</sup> From June 29, 2007, to December 31, 2008, the Federal National Mortgage Association’s<sup>26</sup> market capitalization depreciated from US\$ 63.569 billion to US\$ 4.096 billion. At the close of November 21, 2006, Fannie Mae’s shares traded at US\$ 57.89, at the close of November 21, 2007, the stock price was US\$ 29.23, and at the close of November 21, 2008, the stock price was only US\$30.<sup>27</sup> It is a small wonder that the concept of genius “has worn thin in recent academic work.”<sup>28</sup>

### C. LEGAL ANALYSIS OF ECONOMICS

But, fortunately, law is more than economics. It serves to analyze and correct the orientation of economics that cannot operate without a value system. Law and economics constantly interact with each other. Therefore, the legal analysis of economics is as important as the economic analysis of law.

A prime example for this interaction is the field of accounting, often neglected by lawyers.<sup>29</sup> As soon as financial statements are released to the public, they leave the realms of internal business administration and become a legal disclosure issue.<sup>30</sup> Another example is companies that have become “too big to [let] fail.”<sup>31</sup> The law has to either deny such growth or provide regulations that aim to prevent such companies from needing a government bailout. The same is true when economic concepts overburden markets with complexity. The law then has to provide for

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24. Jon Hilsenrath, Deborah Solomon, & Damian Paletta, *Crisis Mode: Paulson, Bernanke Strained for Consensus in Bailout*, WALL ST. J., Nov. 10, 2008, at A2, A16.

25. *Id.* As a comparison, the bursting of the 1998-2000 “Internet Bubble” was accompanied by a decline in the value of equity securities that may have reached as much as \$7.4 trillion. CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 1-5 (4th ed. 2007).

26. Hereinafter “Fannie Mae.”

27. Deborah Solomon, James R. Hagerty, & Michael Crittenden, *Strains Mount on Bailout Plans*, WALL ST. J., Nov. 11, 2008, at A1, A14.

28. MARK J. ROE, *DELAWARE’S BACKSTOP* 3 (2008), [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=1304165](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1304165).

29. Or as Joseph McLaughlin frequently puts it in his speeches: “Accounting is too important to leave it to the accountants.” Axel Weber, President of Deutsche Bundesbank, in his Opening Statement to the Panel Discussion “Finance after the Turmoil: Shape of Markets and Regulation” at the 18th Frankfurt European Banking Congress (Nov. 21, 2008), *available at* <http://www.bundesbank.de/download/presse/reden/2008/20081121.weber.en.php>.

30. *See generally* Bernhard Grossfeld, *Comparative Accounting*, 28 TEX. INT’L L.J. 233 (1993); Bernhard Grossfeld, *Lawyers and Accountants: A Semiotic Competition*, 36 WAKE FOREST L. REV. 167 (2001); Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards?*, 28 N.C. J. INT’L L. & COM. REG. 847 (2003); BERNHARD GROSSFELD, *Global Accounting: A Challenge for Lawyers*, LAW, CULTURE AND ECONOMIC DEVELOPMENT: A LIBER AMICORUM FOR PROFESSOR ROBERTO MACLEAN 143 (Joseph J. Norton and C. Paul Rogers III eds., 2007).

31. That is, the government would rather inject new cash in such companies than let them go out of business (bailout).

transparency in the interest of fair information and equal playing fields in order to achieve socially balanced results (i.e. “statistical reasoning in law”<sup>32</sup>). Our neglect, in these areas, of the legal analysis of economics contributed to the subprime mortgage fiasco.

## II. SUBPRIME MORTGAGE FIASCO<sup>33</sup>

*“We realized rather late [that] we were trapped in our own concepts which we took for reality.”<sup>34</sup>*

The trust in letters and the refinements of literal complexity seem to have played a decisive role in the subprime mortgage crisis.<sup>35</sup> Mortgage securitization confronts us with a world built of many thousand parcels of land and buildings and many thousand contracts and disclosure documents filled with many hundred thousand words made of millions of letters. It is a formulaic, “letteral” approach painting reality as a pointillist composite.

### A. MORTGAGE SECURITIZATION

In the United States, borrowers typically turn to mortgage brokers.<sup>36</sup> Such brokers then place their customer’s loan application with a lender that issues the credit and receives a note secured by a mortgage in return. Unlike, for example, in Germany where mortgage lenders tend to keep the credit they extend on their books,<sup>37</sup> U.S. lenders quickly refinance themselves by selling their notes and the related mortgages to other financial institutions, typically located on Wall Street. Such institutions then pool such notes and mortgages with many other notes and mortgages in special purpose vehicles<sup>38</sup> that issue new notes to the public, thereby transforming non-liquid assets via a paper construct into exchange traded, asset-backed securities (ABS).<sup>39</sup> This process is commonly referred to as “mortgage securitization.”

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32. Cf. JOSEPH L. GASTWIRTH, 1 STATISTICAL REASONING IN LAW AND PUBLIC POLICY (1988).

33. Gary Gorton, The Panic of 2007 (Aug. 4, 2008)(prepared for the Federal Reserve Bank of Kansas City Jackson Hole Conference), <http://www.kc.frb.org/publicat/sympos/2008/Gorton.08.04.08.pdf>; Gretchen Morgenson, *How the Thundering Herd Faltered and Fell*, N.Y. TIMES, Nov. 9, 2008, at 1.

34. Bernhard Grossfeld, *Global Financial Statements/Local Enterprise Valuation*, 29 J. CORP. L. 337, 361-62 (2004).

35. Regarding the importance of written (in contrast to oral) securities disclosure, see Hansjoerg Heppe, *Is There a Need for New Rule-Making: Securities Offerings, the Internet, and the SEC*, 31 SEC. REG. L.J. 50, 67 et seq. (2003).

36. See Kurt Eggert, *Held Up in Due Course: Predatory Lending, Securitization, and the Holder in Due Course Doctrine*, 35 CREIGHTON L. REV. 503, 553 (2002) (stating that mortgage brokers originate more than sixty percent of all residential loans in the United States).

37. And earn profit from collecting principal and interest.

38. E.g., Lehman Brothers Holdings Inc. used Structured Asset Securities Corporation to securitize its residential mortgages.

39. Joseph C. Shenker & Anthony J. Colletta, *Asset Securitization: Evolution, Current Issues and New Frontiers*, 69 TEX. L. REV. 1369, 1373 (1991).

It was originally developed by Ginnie Mae<sup>40</sup> in the 1970s and quickly became the 'virtuous work' of Freddie Mac<sup>41</sup> and Fannie Mae.<sup>42</sup> Up until 2008, the size and importance of the ABS market became enormous. At the end of 2007, there were US\$ 9.7 trillion ABS outstanding, of which US\$ 7.2 trillion were mortgage-backed securities.<sup>43</sup>

### B. SUBPRIME BORROWERS

The crisis began when the industry started to market towards low-income borrowers. Specific subprime mortgage forms were developed for advertising and selling credit in predominantly low-income neighborhoods, often comprised of minority communities.<sup>44</sup> Typically, borrowers under such forms are less educated than non-subprime borrowers;<sup>45</sup> letters do not reign supreme in their minds. However, just as with the securitization of prime mortgages, refinancing subprime lending profited from the structured, letteral appearance of ABS issues that was enhanced by being accounted for according to generally accepted accounting principles. Positive ratings from credit-rating agencies gave subprime ABS their final touch that originally helped to sustain these 'houses of cards.'<sup>46</sup>

### III. SYSTEMIC ANALYSIS

The trend is to blame the actors and their greed for the subprime mortgage crisis. But that seems too simple. We doubt whether certain individuals or institutions can be responsible for a crisis of this dimension. Most of us are making our living in an environment that we do not control. We are market participants, left with little leeway for a behavior other than what the markets, in case of the subprime mortgage crisis, what the international financial markets, perceive as being good. As market participants, we will be punished if our performance is not in line with industry or general trends. Similarly, investors will not buy bonds if they do not yield a sufficient return and will sell stock if a company's manage-

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40. Formally known as the Government National Mortgage Association.

41. Formally known as the Federal Home Loan Mortgage Corporation.

42. Julia P. Forrester, *Fannie Mae/Freddie Mac Uniform Mortgage Instruments: The Forgotten Benefit to Homeowners*, 72 MO. L. REV. 1077, 1081 *et seq.* (2007); Arnold Kling, *Freddie Mac and Fannie Mae, An Exit Strategy for the Taxpayer* 5 (Cato Institute, Briefing Paper No. 106, 2008).

43. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 1159. *See also* CHARLES J. JOHNSON, JR. & JOSEPH McLAUGHLIN, *CORPORATE FINANCE AND THE SECURITIES LAWS* 14-3 (4th ed. 2007). The ABS market was therefore larger than the U.S. Treasury securities market (\$4.5 trillion) or the \$5.8 trillion corporate bond market. JOHNSON & McLAUGHLIN, *supra* (referring to the U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2006, TABLE 1185).

44. Eggert, *supra* note 36, at 574. *See also* Ricardo Guerra v. GMAC LLC, No. 208 Civ. 01297, 2008 WL 3911765 (E.D. Pa. July 22, 2008) (describing the discrimination issue).

45. Eggert, *supra* note 36, at 576.

46. *See generally* WILLIAM COHAM, *HOUSE OF CARDS: A TALE OF HUBRIS AND WRETCHED EXCESS ON WALL STREET* (Random House, 2009).

ment does not sufficiently focus on shareholder value. Here again, the markets act as arbiter.

Therefore, as lawyers, we should take a ‘bottom-up’ approach and ask ourselves whether there was an intrinsic structure in our legal work that caused unreliable appearances. Were we aware of the social and economic consequences of our legal refinements? Were they too abstract to reflect reality properly? Were we trying to play the rules as effectively as possible, without seeing the statistical implications of our play? Did we sufficiently understand the transactions we were advising on? Did the enormous amount of ‘precise letters’ help to create the subprime mortgage crisis by contributing to and covering-up the complexity of the subject matter?

In this article, we will discuss these questions with regard to a mortgage product that is at the heart of the subprime mortgage crisis, the adjustable-rate mortgage (ARM) loan. Let us examine the details in a lawyerly manner.<sup>47</sup>

#### IV. STRUCTURAL OVERVIEW<sup>48</sup>

##### A. “SOCIAL” DREAMS

Over the last two decades interest rates in the United States were unprecedentedly low. One of the reasons for this development was that the U.S. government tried to realize an American dream: homeownership for as many people as possible.<sup>49</sup> In addition, interest paid on mortgages for primary residences is tax deductible under the U.S. Internal Revenue Code,<sup>50</sup> and Fannie Mae and Freddie Mac’s mission became to provide a continuous, low-cost source of credit to finance America’s housing.<sup>51</sup>

Initially, America’s dream seemed to become true. An unprecedented number of people applied for new or refinanced existing mortgages, having a good feeling about their interest payments because of the tax deductibility.<sup>52</sup> Demand for homes surged, leading (following the laws of supply and demand in a free market economy) to increasing real estate prices. The number of U.S. homeowners grew and U.S. homes became more expensive.

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47. See Scott Reynolds Nelson, *The Real Great Depression*, CHRONICLE REV., Oct. 17, 2008, at B9 (describing similarities between present circumstances and the 1873 crisis).

48. See generally Dustin Fisher, *Selling the Payments: Predatory Lending Goes Primetime*, 41 J. MARSHALL L. REV. 587 (2008); JOHN WIEDEMER, REAL ESTATE FINANCE (6th ed. 2002); HANDBOOK OF MORTGAGE-BACKED SECURITIES (Frank Fabozzi ed., 5th ed. 2001).

49. See generally Cathy Lesser Mansfield, *The Road to Subprime “HEL” Was Paved with Good Congressional Intentions: Usury Deregulation and the Subprime Home Equity Market*, 51 S.C. L. REV. 473 (2000).

50. 26 U.S.C. § 163 (2000).

51. See Fannie Mae, <http://www.fanniemae.com/about/index.html>; Freddie Mac, [http://www.freddie.mac.com/corporate/company\\_profile/faqs/](http://www.freddie.mac.com/corporate/company_profile/faqs/).

52. Note that interest on other personal loans is not tax deductible.



At the same time, taking inflation into account, U.S. treasury interest rates became so low, they became negative. Thus, financial institutions made a profit if they took out debt, and financial investors had to look for riskier, higher yielding returns if they did not want to lose money.

### 1. *Pyramid Scheme*

As hope for new business opportunities and profit potentials entered the scene, however, a pyramid scheme of gigantic proportions began to unfold.<sup>53</sup> Political philanthropy turned into an entrepreneurial venture.

Homeowners that got in early increased their asset base substantially, without significantly increasing their liabilities, by regularly moving into more expensive houses.<sup>54</sup> Other homeowners refinanced existing mortgages to pay for credit card debt<sup>55</sup> or took out so called "110% mortgages," borrowing more money than their home was worth at the time the loan was issued. To sustain this scheme of ever-increasing real estate prices, however, ever new, lower levels of buyers had to be found. The mortgage industry facilitated this search by lowering the entrance barriers to obtain loans.<sup>56</sup> Ultimately, first time home buyers with bad credit were targeted. New products were introduced that appeared to be 'affordable' for low-income borrowers,<sup>57</sup> most notably ARM loans. Suddenly, bad credit made for good loan candidates.<sup>58</sup>

At the same time, the securitization of mortgage loans did not only help to provide a continuous, low-cost source of credit to refinance mortgage lenders, it changed the industry's business model by transferring default risks from the original lenders' books to the ABS investor's portfolio.<sup>59</sup> Lenders no longer earned profits from collecting principal and interest; instead, producing fees and commissions became the name of the game,<sup>60</sup> starting a severe disconnect between the person making the credit decision and the person bearing the default risk.

Making subprime home buyers the new, lowest level of the pyramid kept America's dream alive and initially rewarded everybody. On the

53. In a pyramid scheme, those near or at the top of the pyramid make a lot of money on the supplied products, but those at the bottom are left with inventories of products they cannot sell.

54. See 26 U.S.C. § 1031 (2008) (providing for deferral of capital gains).

55. Cf. Debbie Dragon, Should you Refinance Your Home to Pay Off Credit Card Debt?, <http://www.loan.com/truth-about-loans/how-to-pay-off-credit-card-debt> (last visited July 14, 2009).

56. This took place during 2006 and 2007. Cf. Carrick Mollenkamp, Serena Ng, Liam Pleven and Randall Smith, *Behind AIG's Fall. Risk Models Failed to Pass Real-World Test*, WALL ST. J., Nov. 3, 2008, at A1 ("... to subprime-mortgage bonds issued in the worst years of 2006 and 2007.").

57. Based on these assumptions such products were seen as advantageous financial instruments even for financially weak customers to whom they were pretended as something "good." See Jo Carillo, *Dangerous Loans: Consumer Challenges in Adjustable Rate Mortgages*, 5 BERKELEY BUS. L. J. 1 (2008).

58. See Douglas McGray, *Check Cashers, Redeemed*, N.Y. TIMES MAG., Nov. 9, 2008, at 36.

59. Eggert, *supra* note 36, at 550-554.

60. Essentially themselves becoming 'agents' for Wall Street.

one side, prices for new and existing homes continued to rise, but on the other, loans to subprime borrowers provided for higher default risks and therefore higher interest rates than loans to non-subprime borrowers. Because of the higher interest rates, subprime loans paid higher commissions to mortgage brokers.<sup>61</sup> Mortgage lenders, however, did not need to worry too much about the potential increase in default risks because they securitized such loans. Similarly, Wall Street intended to move most of such risks off its books by selling the subprime ABS into the international financial markets. Investors in these markets, finally, found not only comfort in the fact that—in case there were to be an event of default—the holder of the original note and mortgage could foreclose into the “backing asset.”<sup>62</sup> They also found—at least on paper—the returns they had been looking for to beat inflation.<sup>63</sup>

Thus, a seemingly perfect process provided the cash to keep the pyramid scheme growing.<sup>64</sup>

## 2. *International Nightmare*

Under the ‘soothing melody of perfect markets,’<sup>65</sup> however, this development did not appear as a pyramid scheme. Rising house prices made it easy to refinance and, while improving their credit history by acting in compliance with their first mortgage, borrowers with bad credit could increase their credit scores<sup>66</sup> and thereby their chances of refinancing their ARMs with fixed-rate mortgages or taking out second mortgages. Thus, subprime mortgages did not only seem to make homeownership affordable for the poor, they also fulfilled commercial hopes. And isn’t this what markets are all about? Bringing together diverse and different interests?

But, unfortunately, the disconnect between the person making the credit decision and the person bearing the default risk could not be permanently ignored, as (i) high level credit liquidity cannot continue forever,<sup>67</sup> (ii) buildings wear out and need to be renovated, (iii) new recruits

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61. *Nightmare Mortgages*, BUSINESS WEEK, Sept. 11, 2006, at 1.

62. The securities were more than just paper.

63. Note that the higher interest rates on subprime loans could be passed on in the mortgage securitization process. In addition, investors at home or abroad were not offended by complexity as they relied on Wall Street’s good will as financial advisers. Cf. Katharina Bart, *Swiss Banks Face a Lehman Probe*, WALL ST. J., Nov. 4, 2008, at C3.

64. This also took place during 2006 and 2007. Cf. Mollenkamp et al., *supra* note 56, at A1 (“... to subprime-mortgage bonds issued in the worst years of 2006 and 2007.”).

65. Or, to put it differently, all this was based on the “scientific” assumption that the wisdom of the markets (as Adam Smith’s “invisible hand”) will prevent any abuse. Bernhard Grossfeld, *Language, Poetry and Law: Order Patents*, 10 LAW & BUS. REV. AM. 669, 670 (2004).

66. In the U.S., the “credit score” is a numerical expression based on a statistical analysis of a person’s credit files, to represent the creditworthiness of that person.

67. Landon Thomas Jr. quoting William Conway Jr. who refers to the leveraged buy-out market, *Tight Credit, Tough Times for Buyout Lords*, N.Y. TIMES, Mar. 8, 2008, at C1 (“I know that this liquidity environment cannot go on forever. [...] And I know that the longer it lasts, the worse it will be when it ends.”).

on the lower levels of a pyramid find it more difficult to sell their products because there are more competing salesmen for the same product than when the scheme started, and (iv) a downward economy confronts borrowers with unemployment and makes them default on their loans. The situation became dramatic as home prices plunged from October 2007 to October 2008 by 26.6 percent in Los Angeles, by 27.3 percent in San Francisco and by 28.1 percent in Miami.<sup>68</sup> America's social dream of increased homeownership became an international financial nightmare. Its effects are tragically personal.<sup>69</sup> In 2008, investors are believed to have lost over seventeen trillion dollars (US\$ 17,000,000,000,000).<sup>70</sup>

## B. ADJUSTABLE-RATE MORTGAGES

One of the mortgage products marketed to low-income borrowers was the ARM loan.<sup>71</sup> Unlike traditional thirty-year fixed-rate loans that give cost certainty to borrowers until the respective loan is fully amortized, interest owed on ARM loans will change over the term of the loan according to certain parameters.

### 1. Endorsement

The impetus came when Alan Greenspan wondered out loud, why not more Americans were using ARM loans:<sup>72</sup>

American consumers might benefit if lenders provided greater mortgage product alternatives to the traditional fixed-rate mortgage. To the degree that households are driven by fears of payment shocks but are willing to manage their own interest rate risks, the traditional fixed-rate mortgage may be an expensive method of financing a home.

Mr. Greenspan apparently did not have subprime borrowers in mind, but his credibility encouraged the mortgage industry to use him as an endorsement for ARM products to all customers.

### 2. Mechanics

The first parameter that determines the interest rate payable on ARM loans is the dates on which the interest rate is reset (the Reset Dates). Up to the first Reset Date, the interest rate of an ARM loan is fixed.<sup>73</sup>

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68. Les Christie, *Home Prices See Another Record Plunge*, CNN MONEY, Oct. 28, 2008, at 1.

69. Cf. Kate Kelly, *His Job at Bear Gone, Mr. Fox Chose Suicide*, WALL ST. J., Nov. 6, 2008, at C3.

70. Global Equity Markets End 2008 on a Positive Note; Move Cautiously into 2009, Reuters, Jan. 6, 2009, available at <http://www.reuters.com/article/pressRelease/idUS159817+06-Jan-2009+PRN20090106>.

71. Eggert, *supra* note 36, at 574. See also Ricardo Guerra v. GMAC LLC v. United States, 2008 WL 3911765, No. 208 Civ. 01297 (E.D. Pa. July 22, 2008) (describing the discrimination issue).

72. Benny L. Kass, *Greenspan, ARMs and What's Best for You*, WASH. POST, Mar. 6, 2004, at F10.

73. Set forth in the note.

Thereinafter, it changes, subject to an adjustment cap (the Adjustment Cap), on each Reset Date until the loan is fully amortized.<sup>74</sup> The frequency of Reset Dates will be set forth in the note. The formula for determining the applicable interest rate of an ARM loan on a Reset Date is comprised of (i) a variable rate<sup>75</sup> as the base interest rate (the Index Rate), plus (ii) a certain percentage depending on the credit risk of the borrower (the Margin).<sup>76</sup> Typically, LIBOR<sup>77</sup> is used as the Index Rate. LIBOR is the interest rate offered for U.S. dollar deposits among certain London banks. There are several LIBORs depending on the maturity of the deposit.<sup>78</sup> The specific LIBOR that will be used as Index Rate will be set forth in the note.<sup>79</sup>

### 3. 2/28s and 3/27s

The ARM loans most often marketed to low-income borrowers were so called “2/28-” or “3/27-ARMs.” Just like fixed-rate mortgage loans, ARM loans typically amortize over thirty years. The difference is, however, that ARM loans are separated into two periods—here, one of two years and one of twenty eight years, or one of three years and one of twenty seven years. In a 2/28-ARM, for example, “2” shows the number of years to the first Reset Date (the Initial Period); hence, the interest rate remains fixed for two years. “28” indicates the number of years over which the rate floats according to movements of the Index Rate (the Floating Period). The Initial Period of predictable interest payments for subprime borrowers is therefore comparatively short.

### 4. Interest Rate Hikes<sup>80</sup>

To make 2/28- or 3/27-ARMs ‘affordable,’ such loans often provided for ‘teaser’ rates (i.e. interest rate discounts) during the Initial Period. At the first Reset Date, however, the low monthly payments of the teaser rate would expire and the interest rate would reset to the then current Index Rate plus Margin. Teaser rate ARM loans therefore enticed borrowers with affordable initial interest payments but—by the same token—exposed them to high future increases, limited only by the Adjustment Cap, as their interest rates become subject to the Index

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74. Also set forth in the note.

75. Examples for such rates are the CD Rate, the CMT Rate, the Commercial Paper Rate, the Eleventh District Cost of Funds Rate, EURIBOR, the Federal Funds Rate, the Prime Rate, the Treasury Rate or LIBOR.

76. Or, interest rate = Index Rate + Margin = Adjustable Cap.

77. The London Interbank Offered Rate.

78. LIBORs are quoted from overnight to 12-month maturity.

79. As well as the time and date of the quote of such LIBOR.

80. See generally Kathleen C. Engel & Patricia S. McCoy, *A Tale of Three Markets: The Law and Economics of Predatory Lending*, 80 TEX. L. REV. 1255 (2002).

Rate.<sup>81</sup> As stated above,<sup>82</sup> the reason for significant Margins triggering these interest rate hikes is the high default risk of subprime borrowers.<sup>83</sup> In addition, lenders need to 'make up' for interest rate discounts during the Initial Period.

According to the Conference of State Bank Supervisors, the spread between the initial fixed-rate and the rate during the Floating Period typically ranges from 300 to 600 basis points.<sup>84</sup> On average, an ARM loan interest rate would therefore increase by an additional 4.5% after the first Reset Date. The Commonwealth of Massachusetts Superior Court reviewed 98 ARM loans where the introductory rate varied from 6.1% to 12.4%.<sup>85</sup> On the first Reset Date interest would increase on average by an additional 3%, with the potential of additional increases every six months.<sup>86</sup> We also found references to interest rate increases from 6.95% payable during the Initial Period to 11% and 13.95% payable during the Floating Period, or 7.55% payable during the Initial Period to 13.25% payable during the Floating Period,<sup>87</sup> averaging a hike of an additional 5.5% after the first Reset Date.

### C. REFINANCING PRESSURE

To avoid interest rate hikes on (or after) the first Reset Date, borrowers must therefore refinance ARM loans before such date. Prepayments, however, do not square well with the securitization process because most securitizations amortize over thirty years, the term of the underlying loans. Once a pool has been securitized, all profits are locked in and will shrink if the number of prepayments becomes bigger than anticipated. The common prepayment activity of a pool and its accordance with the forecast during the amortization period is therefore an important concern for lenders and Wall Street. Let us look at the standard terms of a prepayment clause of a fixed-rate note, as well as a prepayment rider to an ARM note, to see how the industry has addressed this matter:

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81. So called "exploding" ARMs. Dustin Fisher, *Selling the Payments: Predatory Lending Goes Primetime*, 41 J. MARSHALL L. REV. 587, n.55 (2008) (quoting Michael D. Calhoun). See also *Hearing On "Calculated Risk: Assessing Non-Traditional Mortgage Products" Before the Senate Committee on Banking, Housing and Urban Affairs Subcommittee on Housing and Transportation and Subcommittee on Economic Policy (Sept. 20, 2006)* (Testimony of Michael D. Calhoun, President, Center for Responsible Lending), available at <http://www.responsiblelending.org/mortgage-lending/policy-legislation/congress/Testimony-Calhoun092006.pdf>.

82. See section above titled "Pyramid Scheme."

83. See Conference of State Bank Supervisors, Statement on Subprime Mortgage Lending, [http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final\\_CSBS-AARMR-NACCA\\_StatementonSubprimeLending.pdf](http://www.csbs.org/Content/NavigationMenu/RegulatoryAffairs/MortgagePolicy/Final_CSBS-AARMR-NACCA_StatementonSubprimeLending.pdf).

84. *Id.* at n. 1.

85. *Commonwealth v. Fremont Inv. & Loan, & Fremont Gen. Corp.*, No. 07-4373-BLS1 (Mass. Sup. Ct. Feb. 25, 2008), at 10, <http://skaddenpractices.skadden.com/cfs/attach.php?uploadFileID=79>.

86. *Id.*

87. Calhoun, *supra* note 81.

### 1. *Standard Clause*

Under a traditional fixed-rate mortgage loan, the borrower is under no pressure to refinance. A typical sample note does not, therefore, penalize the borrower's right to prepay principal and reads as follows:<sup>88</sup>

#### **BORROWER'S RIGHT TO PREPAY**

I have the right to make payments of principal at any time before they are due. A payment of principal only is known as a 'prepayment.' When I make a prepayment, I will tell the Note Holder in writing that I am doing so.

I may make a full prepayment or partial prepayments without paying any prepayment charge. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. If I make a partial prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes.

### 2. *Prepayment Penalties*

Prepayment uncertainty is, however, an important concern for the securitization industry. Also, prepayment of principal reduces the amount of interest that a lender receives on a loan. This is especially true for teaser rate ARM loans, where discounts given during the Initial Period need to be compensated for during the Floating Period. Lenders therefore try to discourage borrowers from refinancing.

Fourteen of the ninety-eight ARM loans reviewed in Massachusetts provide for prepayment penalties of up to six months' worth of interest if the borrower prepaid the note during the Initial Period (due to selling the home or refinancing the ARM loan).<sup>89</sup> Farris and Richardson found that less than two percent of prime mortgages contain prepayment penalty provisions, versus up to eighty percent of subprime mortgages.<sup>90</sup> Such penalties ranged between one and six percent of the original loan balance.<sup>91</sup> A prepayment rider to an ARM note currently in dispute before the Virginia Eastern District Court reads as follows:<sup>92</sup>

#### **BORROWER'S RIGHT TO PREPAY**

I have the right to make payments of Principal at any time before they are due. A payment of Principal only is known as a 'Prepayment.' When I make a Prepayment, I will tell the Note Holder in writing that I am doing so. I may not designate payment as a Prepay-

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88. WILLIAM BRONCHICK, *FINANCING SECRETS OF A REAL ESTATE MILLIONAIRE* 151 (2003).

89. *Fremont Investment & Loan and Fremont General Corp.*, *supra* note 85, at 10.

90. JOHN FARRIS & CHRISTOPHER RICHARDSON, *THE GEOGRAPHY OF SUBPRIME MORTGAGE PREPAYMENT PENALTY PATTERNS IN HOUSING POLICY DEBATE* 687, 688 (Fannie Mae Found. 2004).

91. Bronchick, *supra* note 88, at 49.

92. Statement of Undisputed Facts by Lisa Barrigan, *Elite Funding, Decision One*. Attach. 1 Ex. 20, *Barrigan v. Elite Funding et al*, No. 1:07 Civ. 0951 (E.D. Va. Sept. 20, 2007).

ment if I have not made all the monthly payments due under the Note.

I may make a partial prepayment without paying any prepayment charge. If I make a full prepayment within one (1) year of the date of this Note, I agree to pay a prepayment charge of 2% of the amount being prepaid; if I make a full prepayment more than one (1) year but within two (2) years of the date of this Note, I agree to pay a prepayment charge of 2% of the amount being prepaid. The Note Holder will use all of my prepayments to reduce the amount of principal that I owe under this Note. However, the Note Holder may apply my Prepayment to the accrued and unpaid interest on the Prepayment amount, before applying my Prepayment to reduce the Principal amount of the Note. If I make a partial prepayment, there will be no changes in the due date or in the amount of my monthly payment unless the Note Holder agrees in writing to those changes. My partial prepayment may reduce the amount of my monthly payments after the first Change Date following my partial prepayment. However, any reduction due to my partial prepayment may be offset by an interest rate increase.

### 3. *Consumer Education*

Were borrowers under 2/28-ARMs aware of the price they had to pay over a twenty-eight year period for two years of low interest during the Initial Period? The Federal Real Estate Settlement Procedures Act (RESPA)<sup>93</sup> requires lenders and mortgage brokers to give their customers an information booklet called "Buying Your Home"<sup>94</sup> that is prepared by the U.S. Department of Housing and Urban Development.<sup>95</sup> "Buying Your Home" is designed to help perspective borrowers understand "the home buying, home financing, and settlement process."<sup>96</sup> The current version is twenty-two pages long. "Shopping for a Loan" is discussed in Article II on pages five to eight. Its reference to ARM loans reads as follows:

If you apply for a variable rate loan, also known as an adjustable rate mortgage ("ARM"), a disclosure and booklet required by the Truth in Lending Act will further describe the ARM.

That booklet is titled "Consumer Handbook on Adjustable Rate Mortgages" and also measures twenty-two pages. Article III of "Buying Your Home" discusses "Your Settlement Cost" on pages fourteen to twenty-two. Amongst others, there are Sections on "Sales/Broker's Commission," "Items Payable in Connection with Loan,"<sup>97</sup> "Escrow Account De-

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93. 12 U.S.C. § 2601.

94. See <http://www.mortgagesfinancingandcredit.org/mortgages/buying-home-settlement/costs1.htm>.

95. Office of Housing-Federal Housing Administration.

96. See Dept. of Housing and Urban Development, <http://www.hud.gov>.

97. Such as "Credit Report Fee" or "Assumption Fee."

posits” and “Lead-Based Paint Inspections.” We find that the booklet’s overall character is best expressed by Article III’s last Section:

Total Settlement Charges: The sum of all fees in the borrower’s column entitled ‘Paid from Borrower’s Funds at Settlement’ is placed here. This figure is then transferred to line 103 of Section J, ‘Settlement charges to borrower’ in the Summary of Borrower’s Transaction on page 1 of the HUD-1 Settlement Statement and added to the purchase price. The sum of all the settlement fees paid by the seller are transferred to line 502 of Section K, Summary of Seller’s Transaction on page 1 of the HUD-1 Settlement Statement.

Who, other than accountants and lawyers, understands these instructions? Thus, such booklets—written in a language from lawyers to lawyers—were of little help because “almost no one ever reads them before signing.”<sup>98</sup>

#### 4. Financial Consequences

The Practising Law Institute (PLI), holding a “Subprime Institute” in September of 2008, describes the financial consequences to a borrower under a 30-year Fixed-Rate Mortgage and a 2/28-ARM loan, each in the amount of US\$ 200 thousand with the following examples:<sup>99</sup>

	Fixed-Rate Mortgage	2/28-ARM
<b>Interest Rate</b>	7.5%.	7% for Years 1-2, then adjusting to Index Rate plus Margin, subject to annual Adjustment Caps: 10% Adjustment Cap in Year 3; 11.5% Adjustment Cap in Year 4; 13% Adjustment Cap in Years 5-30.
<b>Required Monthly Payments</b> (including\$ 200 per month for real estate tax and insurance escrow)		
<b>Years 1-2</b>	\$1,598	\$1,531
<b>Year 3</b>	\$1,598	\$1,939
<b>Year 4</b>	\$1,598	\$2,152
<b>Years 5-30</b>	\$1,598	\$2,370

If we add these numbers, we will get the following results: Under the fixed-rate mortgage, the borrower would owe the total amount of US\$ 575,280<sup>100</sup> (including certain estimated costs for real estate tax and insurance escrow) if he purchased a home. Under the 2/28-ARM, he may be exposed to a maximum total amount of US\$ 825,294<sup>101</sup> (including certain

98. James R. Hagerty, *New Mortgages Rules Aimed at Consumer*, WALL ST. J., Nov. 12, 2008, at D3.

99. ROBERTA K. MCINERNEY, FINANCIAL INSTITUTION GUIDANCE IN PLI COURSE HANDBOOK, SUBPRIME CREDIT CRISIS: EVERYTHING YOU NEED TO KNOW 15 (Practicing Law Inst. 2008). See also FDIC, Statements of Policy, <http://www.fdic.gov/regulations/laws/rules/5000-5200.html>.

100. Thirty years = 360 months. 360 x \$1,598 = \$575,280.

101. Years one to two = twenty-four months. 24 x \$1,531 = \$36,744. Year three = twelve months. 12 x \$1,939 = \$23,268. Year four= twelve months. 12 x \$2,152 =



estimated costs for real estate tax and insurance escrow). Two years of lower interest payments on a loan in the amount of US\$ 200,000 may therefore be 'made up' by an amount of up to US\$ 250,014.

The Conference of State Bank Supervisors, also looking at 2/28-ARMs, came to similar conclusions.<sup>102</sup> By way of example, a 2/28-ARM loan in the amount of US\$ 200,000 with an initial fixed-rate of 7% may 'typically' reset to LIBOR plus percent.<sup>103</sup> Thus, if the LIBOR designated by the note at the time of the application for the loan equals 5.5%,<sup>104</sup> mortgage brokers and lenders should treat such loan as if it was a fixed-rate mortgage with an interest rate of 11.5%,<sup>105</sup> regardless of the interest rate charged during the Initial Period or any Adjustment Cap.<sup>106</sup> Similarly, the borrower would owe US\$ 1,531 per month during the Initial Period and an estimated US\$ 2,156 per month during the Floating Period on this loan, including US\$ 200 per month for real estate tax and insurance escrow during the entire amortization period.<sup>107</sup> This represents a 41% increase in payment amount on the first Reset Date<sup>108</sup> and would expose the borrower to a total amount of US\$ 761,160<sup>109</sup> (including certain estimated costs for real estate tax and insurance escrow) because of his home purchase. The difference between the 'typical' and the maximum exposure in connection with a 2/28 ARM<sup>110</sup> in the amount of US\$ 200,000 is therefore US\$ 64,134, while the 'typical' exposure is still US\$ 185,880 over the total amount of a 7.5% fixed-rate mortgage.

In addition to determining the payment increase on the first Reset Date, the Conference of State Bank Supervisors puts the increase into perspective. The annual income of a borrower, who would 'typically' take out a loan in this amount,<sup>111</sup> is US\$ 42,000 per year.<sup>112</sup> His initial debt-to-income (DTI) ratio is therefore forty-four percent; upon the first Reset Date it would increase to sixty-two percent.<sup>113</sup>

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\$25,824. Years five through thirty = 312 months.  $312 \times \$2,370 = \$739,440$ .  $\$36,744 + \$23,268 + \$25,824 + \$739,440 = \$825,294$ .

102. Conference of State Bank Supervisors, *supra* note 83.

103. *Id.* at n. 8.

104. Six months USD LIBOR ranged from 1.75000 percent to 4.56625 percent during 2008.

105. This equals Margin plus Index Rate = 6 percent + 5.5 percent.

106. Conference of State Bank Supervisors, *supra* note 83, at n.8.

107. *Id.* at n.14.

108. *Id.*

109. Years one to two = twenty-four months.  $24 \times \$1,531 = \$36,744$ . Years three through thirty = 336.  $336 \times \$2,156 = \$724,416$ .  $\$36,744 + \$724,416 = \$761,160$ .

110. That amortizes over thirty years.

111. The median income of all households in 2006 was \$48,201.00. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 669.

112. Conference of State Bank Supervisors, *supra* note 83, at n. 14.

113. *Id.*

D. SECURITIZATION IMPLICATIONS<sup>114</sup>

Mortgage securitization provided the cash that started lending to subprime borrowers, and subprime lending provided the cash that kept mortgage securitization going. By transferring default risks to Wall Street and then to the financial markets, mortgage securitization also changed the industry's business model. When loans transferred into pools were diversified not only by geography but also by creditworthiness of the borrowers, such transfers became even harder to parse. Structuring risk through securitization was supposed to make risk more manageable, by using senior/subordinate shifting of interest and excess spread/overcollateralization structures in one transaction, however, additional complexity was created.<sup>115</sup> For the person not directly involved in the respective transaction, the risks securitized became easily overlooked; a false sense of security was created.<sup>116</sup>

1. *Self Interest*

Mortgage securitization supported a decline in lending standards. By shifting the industry's business model,<sup>117</sup> securitization 'atomized' the loan process.<sup>118</sup> It created a chain of intermediaries,<sup>119</sup> running from broker, via mortgage lender and Wall Street, to investors.<sup>120</sup>

a. *Loss of Responsibility*

The effect was that (i) the chain-link making the credit decision was not connected to the chain-link bearing the default risk, and (ii) each intermediary-link could deny responsibility for the actions of the others.<sup>121</sup> Just as much as the desire for higher commissions,<sup>122</sup> this aspect of securitization explains why home loans to low-income borrowers became attractive to the industry.<sup>123</sup> Gary Gorton came to the following conclusion:<sup>124</sup>

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114. Eggert, *supra* note 36, at 534. See also Richard C. Jordan, *Will the Bubble Burst? Some Subprime Lessons for Mexico, Latin America's Leader in Asset Securitizations*, 42 INT'L LAW. 1179 (2008).

115. Gorton, *supra* note 33, at 24.

116. Some financial institutions had been trying to assess the fall out of the subprime mortgage crisis for over one year. Cf. *Riding out the subprime crisis*, THE ECONOMIST, Nov. 4, 2007.

117. See section above titled "Pyramid Scheme."

118. Kurt Eggert, referring to: *Subprime Mortgage Market Turmoil: Examining the Role of Securitization Before the Subcomm. on Securities, Insurance, and Investments*, at 8 (Apr. 17, 2007) (statement of Michael Jacobides) available at [http://banking.senate.gov/public/\\_files/eggert.pdf](http://banking.senate.gov/public/_files/eggert.pdf).

119. See generally PAUL MUOLO & MATHEW PADILLA, CHAIN OF BLAME, HOW WALL STREET CAUSED THE MORTGAGE AND CREDIT CRISIS (2008).

120. Eggert, *supra* note 118, at 8.

121. Eggert, *supra* note 36, at 552.

122. See section above titled "Pyramid Scheme."

123. Karl Gelles, *Why banks are Squeezing Credit Card Holders*, USA TODAY, Nov. 10, 2008, at A1.

124. Gorton, *supra* note 33, at 76.

The design of subprime mortgages is unique in that they are linked to house price appreciation. The securitization of subprime mortgages is also unique. Because subprime mortgages are financed through a chain of securities and structures, investors could not easily determine the location and extent of the risk. Information was lost. The house price declines led to a fear of losses that could not be measured because the subprime risk had been spread around the globe opaquely. The available information was on the side of the market that produced the chain of structures; outside investors knew much less. The problem is that the magnitude of the structures, and their impenetrability by outsiders, was not completely understood; it was not common knowledge.

b. Originate-to-Distribute

Another aspect of mortgage securitization is its transformation of non-liquid assets into exchange traded securities. While in 1990, US\$ 380 billion, in 1995, US\$ 348 billion, and in 2000, US\$ 684 billion of mortgage-backed securities were issued, such numbers skyrocketed to US\$ 3.1 trillion in 2003, US\$ 1.8 trillion in 2004, and US\$ 2.0 trillion in 2005, 2006, and 2007, respectively.<sup>125</sup> Because mortgage-backed securities became so popular, at one point, home loans were not originated to provide financing to borrowers, they were originated to induce borrowers into financing (or refinancing) in order to create fees and assets for securitization pools.

From chain-link to chain-link, however, the pictorial, 'real' problems of the respective financed property, such as location and character of the home or creditworthiness of the borrower, disappeared behind a veil of literal abstractions. Some therefore hold that this "originate-to-distribute" approach offers the best explanation for the subprime mortgage crisis.<sup>126</sup>

The originate-to-distribute model . . . created some severe incentive problems, which are referred to as . . . agency problems, in which the agent (the originator of the loans) did not have the incentives to act fully in the interest of the principal (the ultimate holder of the loan). Originators had every incentive to maintain origination volume, because that would allow them to earn substantial fees, but they had weak incentives to maintain loan quality.<sup>127</sup>

c. Only Pieces of the Puzzle

The above listed reasons, however, should not be overstated. Home loan originators suffered from the subprime mortgage crisis along with

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125. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 1159.

126. Gorton, *supra* note 33, at 68.

127. Frederic Mishkin, Speech at the U.S. Policy Forum in New York City: Leveraged Losses: Lessons from the Mortgage Meltdown (Feb. 29, 2008) *available at* <http://www.federalreserve.gov/newsevents/speech/mishkin20080229a.htm>.

the rest of the industry, as losses were suffered up and down the chain.<sup>128</sup> House price depreciation was the single most important factor that hit all links. The decline in lending standards is therefore “only a piece of the puzzle.”<sup>129</sup> The widespread irrationality of subprime lending was based on the belief that the prices for houses would not fall.<sup>130</sup>

## 2. Accounting

At the same time, U.S. generally accepted accounting principles (GAAP) did not only enhance the letteral appearance of ABS issues, they did not expose the consequences of subprime lending either. And when the subprime mortgage crisis began, GAAP contributed to its acceleration.

### a. Special Purpose Vehicles

Wall Street pools home loans in special purpose vehicles. FASB Interpretation No. 46, *Consolidation of Variable Interest Entities*, revised December 2003 (FIN 46R)<sup>131</sup> and Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities*, issued September 2000 (FAS 140)<sup>132</sup> govern the accounting for such special purpose vehicles. FIN 46 was originally issued in January 2003 to govern the kind of off-balance-sheet vehicles whose sudden return to the group accounts wreaked havoc on Enron Corp. FIN 46R measures seventy-nine pages, FAS 140 is 142 pages long; both are of frightening complexity.<sup>133</sup> Their bottom line, however, is scarily simple: Special purpose vehicles used for securitization may still not have to be consolidated.

That is why certain risks did not exist for outsiders. A need for more funding and more capital was not apparent. Pooling subprime mortgage loans created a considerable cluster risk, a warning signal for the markets. Such signal did, however, not readily appear in the group accounts of Wall Street, as value changes of assets in the securitized pools were absorbed by the special purpose vehicles and not by the group. If assets are controlled by the special purpose vehicle and risks are regarded as being

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128. Gorton, *supra* note 33, at 69.

129. Gorton, *supra* note 33, at 75.

130. *Id.*

131. Financial Accounting Standards Board [FASB], FASB Interpretation No. 46, *Consolidation of Variable Interest Entities* (revised Dec. 2003), available at <http://www.fasb.org/fin46r.pdf> [hereinafter FIN 46R].

132. FASB, Statement of Financial Accounting Standards No. 140, *Accounting for Transfers and Services of Financial Assets and Extinguishments of Liabilities*, (issued Sept., 2000), available at <http://www.fasb.org/pdf/fas140.pdf> [hereinafter FAS 140].

133. Cf. *Billy v. Arthur Young & Co.*, 834 P.2d 745, 750-752 (Cal. 1992); Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards?*, 28 N. C. J. INT'L L. & COM. REG. 847, 853 (2003).

dispersed effectively<sup>134</sup> such variable interest entities will not be consolidated and do not appear in the financial statements of the group.<sup>135</sup> Special purpose vehicles used in connection with securitizations therefore continued to make a 'mockery' of the disclosure rules for public companies.<sup>136</sup>

FIN 46R and FAS 140 have since come under public scrutiny. The Financial Accounting Standards Board has proposed amendments:<sup>137</sup> on September 15, 2008, it issued two exposure drafts—*Amendments to FASB Interpretation No. 46 (R)*<sup>138</sup> and *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140*.<sup>139</sup>

#### b. Fair Value Accounting

U.S. GAAP did not, however, only affect the origination side of securitization. Wall Street was unable to move all of its ABS issues into the markets. It and other financial institutions hold ABS as part of their portfolio. A new accounting technique named 'mark-to-market' accounting, introduced during the onset of the subprime mortgage crisis, caught the industry off guard and exacerbated the problems.

Statement of Financial Accounting Standards No. 157, *Fair Value Measurements*, issued September 2006 (FAS 157)<sup>140</sup> became effective for financial statements issued for fiscal years beginning after November 15, 2007, and interim periods within those fiscal years. FAS 157 changed the way companies have to report the value of most of their assets. According to FAS 157, the reported values must reflect the prices a company would receive if such assets were sold "in an orderly transaction between market participants at the measurement date." Because reports are due each quarter, the measurement is performed every three months. By requiring regular evaluations, FAS 157 shifted important power from management to accounting firms.<sup>141</sup> But FAS 157 did more than putting accountants at the fore of decision making about the valuation of a com-

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134. And no single party holds an interest or combination of interests that effectively recombines such risks.

135. Gary Gorton & Nicholas S. Souleles, *Special Purpose Vehicles and Securitization* (FRB Philadelphia, Working Paper No. 05-21, 2005), available at [http://papers.ssrn.com/sol3/papers.cfm?abstract\\_id=713782](http://papers.ssrn.com/sol3/papers.cfm?abstract_id=713782); Jalal Soroosh & Jack Ciesielski, *Accounting for Special Purpose Entities Revised: FASB Interpretation 46 (R)*, CPA JOURNAL, July 2004.

136. Stephen Schwarzman, *Some Lessons of the Financial Crisis*, WALL ST. J., Nov. 4, 2008, at A19.

137. See FASB Board Minutes for May & June 2008, available at [http://www.fasb.org/board\\_meeting\\_minutes/board\\_meeting\\_minutes.shtml](http://www.fasb.org/board_meeting_minutes/board_meeting_minutes.shtml).

138. FASB, *Amendments to FASB Interpretation No. 46 (R)* (Sept. 14, 2008), available at [http://www.fasb.org/draft/ed\\_amend\\_fin46r.pdf](http://www.fasb.org/draft/ed_amend_fin46r.pdf).

139. FASB, *Accounting for Transfers of Financial Assets, an amendment of FASB Statement No. 140* (Sept. 14, 2008), available at [http://www.fasb.org/draft/ed\\_transfers\\_financial\\_assets\\_amend\\_st140.pdf](http://www.fasb.org/draft/ed_transfers_financial_assets_amend_st140.pdf).

140. FASB, *Statement of Financial Accounting Standards No. 157, Fair Value Measurements*, issued September 2006 (FAS 157)(effective Nov. 15, 2007)[http://www.fasb.org/pdf/aop\\_FAS157.pdf](http://www.fasb.org/pdf/aop_FAS157.pdf).

141. Gorton, *supra* note 33, at 64.

pany's assets. Because marking-to-market is also applied to hard-to-value assets for which there is no readily observable market, when liquidity dries out, no market prices occur and such asset must be written down substantially.

As ABS are typically held for long term investment, even when traded on an exchange, their market is not very broad. The liquidity drought caused by subprime mortgage crisis therefore destroyed their fungibility and eliminated their value. Mortgage-backed securities were priced not in terms of probability of default, but in terms of what such securities would fetch if they had to be sold at the measurement date. Over the course of the subprime mortgage crisis, ABS prices plummeted below any value determined by the risk of default. In April 2008, for example, the Bank of England estimated that, based on actuarial methods, the credit losses in connection with this crisis would eventually reach US\$ 170 billion,<sup>142</sup> whereas, following mark-to-market valuation, mortgage-backed securities had already lost around US\$ 380 billion of their value.<sup>143</sup>

Section 132 of the Emergency Economic Stabilization Act of 2008 (EES Act)<sup>144</sup> restated the Securities and Exchange Commission's authority to suspend the application of fair value accounting rules "if the Commission determines that is necessary or appropriate in the public interest and is consistent with the protection of investors." Section 133 of the EES Act requires the Securities and Exchange Commission, in consultation with the Board of Governors of the Federal Reserve System and the Secretary of the Treasury, to conduct a study on mark-to-market accounting, including, but not limited to, its (i) effects on a financial institution's balance sheet, and (ii) impact on the quality of financial information available to investors. On December 30, 2008, the Commission published a study recommending improvements to the existing practice but not suspending mark-to-market accounting.<sup>145</sup>

### 3. Positive Ratings

The letteral appeal of ABS, accounted for under U.S. GAAP, was complimented by an easily understandable rating system. Mortgage-backed security issues are typically divided into different tranches with different seniority. Losses inside a pool are generally applied to the tranches in reverse order of seniority. To compensate for the added default risk, junior tranches offer higher interest rates than senior tranches. Rating agencies followed this approach: (i) the senior tranche is generally rated AAA, (ii) the one or more mezzanine tranches, they rate AA to BB, and (iii) the equity tranches are typically left unrated. As ABS issues

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142. Bank of England, *Financial Stability Report*, 18 (Apr. 2008), available at <http://www.bankofengland.co.uk/publications/fsr/2008/fsrfull0804.pdf>.

143. *Id.* at 19.

144. 12 U.S.C. § 5201 (2008).

145. See Securities and Exchange Commission, *Congressionally-Mandated Study Says Improve, Do Not Suspend, Fair Value Accounting Standards* (Dec. 30, 2008) available at <http://sec.gov/news/press/2008/2008-307.htm>.

became more and more complicated—senior/subordinate shifting of interest and excess spread/overcollateralization structures were combined in one transaction—because mortgages are not priced on an open market, such ratings were based on little tested models. Rating different mortgage-backed security tranches became extremely difficult.<sup>146</sup> Stephen Joynt of Fitch Ratings remarked:<sup>147</sup> “We weren’t able to project forward.”

But what is rating about if not projecting forward? The purported blindness of the rating agencies is even more surprising, as the cluster risks created by the pooling of subprime mortgage loans were visible from the beginning.

#### 4. *Pretend Insurance*<sup>148</sup>

In an effort to provide against these cluster risks, financial institutions started engaging in Credit Default Swaps (CDS). A CDS is a credit ‘derivative’ contract in which the buyer of the CDS makes a series of payments to the seller and, in exchange, receives a payoff if a specified credit event occurs. Such credit event is typically the default of a bond or a loan.<sup>149</sup> It is, however, not necessary for the buyer to be affected by such credit event. But the lack of an insurable interest is not the only difference that distinguishes the CDS business from the insurance business. Unlike an insurance company, the seller of a CDS does not need to be a regulated entity<sup>150</sup> (for example, AIG Financial Products Corp.), and, unlike an insurance contract, CDS are generally subject to mark-to-market accounting.<sup>151</sup>

During the dawn of the subprime mortgage crisis, however, betting on the materialization of certain default risks, or other credit events, became so popular that the notional amounts of outstanding CDS increased to about US\$ 58 trillion (US\$ 58,000,000,000,000).<sup>152</sup> At the same time, for example, the volume of all debt securities issued and outstanding in the

146. Aaron Lucchetti & Judith Burns, *Moody’s CEO Warned Profit Push Posed a Risk to Quality of Ratings*, WALL ST. J., Oct. 23, 2008, at A4, available at <http://online.wsj.com/article/SB122471995644960797.html#>.

147. Pallavi Gogoi, *Credit Rater’s Judgment Questioned*, USA TODAY, Oct. 23, 2008, at 3B, available at <http://abcnews.go.com/Business/story?id=6090528&page=1>.

148. See generally Judy J. Kim, *Credit Default Swaps Get Attention of U.S. Regulators*, BLOOMBERG LAW REPORTS, RISK & COMPLIANCE (Nov. 2008); Claus Luttermann, *Kreditversicherung (Credit Default Swaps): Vertrag, Restrukturierung und Regulierung (Hedge-Fonds, Rating, Schattenbanken)*, RECHT DER INTERNATIONALEN WIRTSCHAFT at 737 (Nov. 2008).

149. Less commonly, the credit event that triggers the payoff can be a company’s credit rating being downgraded or a company undergoing restructuring or bankruptcy.

150. Eggert, *supra* note 36, at 550. (Eggert therefore describes them as “completely lacking in transparency and completely unregulated.”)

151. See above section titled “Fair Value Accounting.”

152. Bank for Economic Development, Monetary and Economic Department, *OTC derivatives market activity in the second half of 2007*, May 2008, at 1, available at [http://www.bis.org/publ/otc\\_hy0805.pdf?noframes=1](http://www.bis.org/publ/otc_hy0805.pdf?noframes=1).

United States was US\$ 29.7 trillion.<sup>153</sup> “To put into [yet another] context this US\$ 58 trillion of value that credit default swaps insure: US\$ 58 trillion is more than the gross domestic product of every country on earth, combined.”<sup>154</sup>

But the sheer magnitude of the CDS market is not the only circumstance that became breathtaking. In April 2008, AIG Financial Products Corp. committed to pay certain employees retention bonuses in the amount of US\$ 450 million to stay on board.<sup>155</sup> AIG needed such employees to unwind its CDS business, as they were deemed to be the only ones who understood the business and were capable of unwinding it.<sup>156</sup> By March 2009, its parent company, American International Group, Inc., is considered to have received at least US\$ 170 billion in U.S. bailout money since September 2008,<sup>157</sup> and AIG Financial Products Corp. is deemed to have destroyed AIG.<sup>158</sup>

The combination of mortgage-backed securities and CDS worked as paper built Archimedean lever. Unfortunately it failed to pass the real-world test.<sup>159</sup>

## V. COMPLEXITY

The structural overview shows that the instruments invented to minimize the risks involved in mortgage lending led to unprecedented levels of complexity. The chain of transactions and the securities involved make it almost impossible to determine the location and extent of the risk:<sup>160</sup> “[I]t is not possible to penetrate the chain backwards and value the chain based on the underlying mortgages. . . . There are (at least) two layers of structured products in CDOs. Information is lost because of the difficulty of penetrating to the core assets.”<sup>161</sup>

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153. U.S. CENSUS BUREAU, STATISTICAL ABSTRACT OF THE UNITED STATES: 2009, TABLE 1159, available at <http://www.census.gov/prod/2006pubs/07statab/banking.pdf>.

154. Christopher Cox, SEC Chairman, Opening Remarks at SEC Roundtable on Modernizing the Securities and Exchange Commission's Disclosure System (Oct. 8, 2008), available at <http://www.sec.gov/news/speech/2008/spch100808cc.htm>.

155. Edmund Andrews and Peter Baker, *Bonus Money at Troubled A.I.G. Draws Heavy Criticism*, THE N.Y. TIMES, Mar. 15, 2009, at 1, available at <http://www.nytimes.com/2009/03/16/business/16aig.html>.

156. See Jim Zarroli, *Obama, Cuomo Target AIG Bonuses*, NPR, Mar. 16, 2009, available at <http://www.npr.org/templates/story/story.php?storyId=101963181>.

157. See Matthew Karnitschnig, Deborah Solomon, Liam Plevin & Jon E. Hilsenrath, *U.S. to Take Over Ailing AIG in \$85 Billion Bailout; Central Banks Inject Cash as Credit Dries Up*, WALL ST. J., Sept. 16, 2008, at A1, available at <http://online.wsj.com/article/SB122156561931242905.html>.

158. Monica Langley, Deborah Solomon & Matthew Karnitschnig, *Bad Bets and Cash Crunch Pushed Ailing AIG to Brink*, WALL ST. J., Sept. 18, 2008, at A1, available at <http://online.wsj.com/article/SB122169421247449935.html>. Cf. Mollenkamp et al., *supra* note 56, at A1; *AIG names recipients of its bailout money*, CNN, Mar. 16, 2009, <http://www.cnn.com/2009/US/03/15/AIG.banks.list/index.html>.

159. *Financial WMD*, USA TODAY, Oct. 22, 2008, at 8A (and became “financial weapons of mass destruction”) (quoting Warren Buffet).

160. Gorton, *supra* note 33, at 45.

161. Gorton, *supra* note 33, at 61.



Law therefore became an instrument of complexity, reducing transparency from beginning to end.<sup>162</sup>

#### A. AT THE BOTTOM

The complexity started with selling ARM loans to borrowers. An ARM loan does not look too complicated to the expert, but it seems that borrowers who actually submitted to 2/28-ARMs did not understand their economic consequences. This is due to the fact, that in matters of interest we meet imperfect information. The “ignorant borrower”<sup>163</sup> is typically not familiar with the power of interest and compound interest.<sup>164</sup> He is not aware of the “Rule of 72”—72 divided by the annual interest rate provides the number of years it takes for the amount to be actually repaid on a debt to double.<sup>165</sup> At the bottom we find information asymmetry.

#### B. ALONG THE LINKS

The complexity of ABS continued along the links. A good example is Structured Asset Securities Corporation’s last registration statement on Form S-3 (Amendment No. 3) that it filed with the Securities and Exchange Commission (SEC) on June 29, 2007.<sup>166</sup> The Structured Asset Securities Corporation was a special purpose vehicle of Lehman Brothers Holdings Inc. for the issue of ABS.

The first sample base prospectus contained in this registration statement measures 187 pages plus Index of Principal Terms, Annex A Book-Entry Procedures, and Annex B Global Clearance, Settlement and Tax Documentation Procedures. Its Table of Contents is three pages long, referring to twenty-six chapters. They start with Risk Factors, Description of the Securities, and The Trust Funds, deal with Servicing of Loans, Credit Support and Derivatives, and conclude with Additional Information, Incorporation of Certain Documents by Reference (i.e. more documents to be aware of) and Reports to Security Holders.

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162. Cf. Bernhard Grossfeld, *Comparative Corporate Governance: Generally Accepted Accounting Principles v. International Accounting Standards*, 28 N.C. J. INT’L L. & COM. REG. 847, 853 (2003).

163. RASHMI DYAL-CHAND, FROM STATUS TO CONTRACT: EVOLVING PARADIGMS FOR REGULATING CONSUMER CREDIT, THE FUTURE OF CONSUMER CREDIT REGULATIONS 49, 59 (Michelle Kelly-Louw, James P. Nehf & Peter Rott eds., 2008).

164. See generally Mary Spector, *Taming the Beast: Payday Loans, Regulatory Efforts, and Unintended Consequences*, 57 DEPAUL L. REV. 961 (2008); Steven M. Graves & Christopher L. Peterson, *Usury Laws and the Christian Right: Faith-Based Political Power and the Geography of American Payday Loan Regulation*, 57 CATH. U. L. REV. 637 (2008); Christopher L. Peterson, *Usury Law, Payday Loans, and Statutory Sleight of Hand: Salience Distortion in American Credit Pricing Limits*, 92 MINN. L. REV. 1110 (2008).

165. See *The Rule of 72, Better Explained*, Jan. 25, 2007, available at <http://www.betterexplained.com/articles/the-rule-of-72/>.

166. Structured Asset Securities Corp., Securities and Exchange Commission [SEC], Amendment No. 3 to Registration Statement (S-3) (June 29, 2007), available at <http://www.secinfo.com/d13f21.umb.htm#1stPage>.

The Index of Principal Terms alone covers four and one-half pages. Risk Factors are explained on thirty-three pages. They discuss, among others matters, typical weaknesses of subprime mortgage loans such as Higher Expected Delinquencies, the effects of Changes in the U.S. Economic Conditions as well as Prepayment Premiums, Negative Amortization and Geographic Concentration. As characteristic we quote the explanation of prepayment penalties in connection with home loans:

Many residential mortgage loans, particularly adjustable rate mortgage loans, negative amortization mortgage loans and subprime mortgage loans, require the payment of a prepayment premium in connection with voluntary prepayments of the mortgage loan made during the period specified in the related mortgage note. These prepayment premiums may discourage borrowers from refinancing their mortgage loans, and in many cases, may discourage borrowers from selling the related mortgage property, during the applicable period. Borrowers who wish to refinance their properties to take advantage of lower interest rates, or who want to sell their mortgaged property, may not be able to afford the prepayment premium and may be more likely to default. You should consider the effect of these prepayment premiums on borrowers and the resulting effect on the yields of your securities.<sup>167</sup>

The risk factors end with a global warning:

The Securities May Not Be Suitable Investments. The securities may not be a suitable investment if you require a regular or predictable schedule of payment, or payment on any specific date. . . . An investment in these types of securities involves significant risks and uncertainties and should only be considered by sophisticated investors who, either alone or with their financial, tax and legal advisors, have carefully analyzed the mortgage loans and the securities and understand the risks.<sup>168</sup>

After the risk factors, the ABS to be issued by the Structured Asset Securities Corporation are explained on six and one-half pages. Over twenty-two pages are spent on the home loans that may be included in a trust fund; another three and one-half pages describe the underwriting procedures and standards for such loans. The next part presents on fourteen and one-half pages the sponsor (Lehman Brothers Holdings Inc.), the depositor (Structured Asset Securities Corporation), and the master servicer of the loans in the trust fund (Aurora Loan Services LLC), including an eleven page section on Servicing before 'the' Servicing of Loans is explained on another twelve pages.

Altogether, an impressive legal document. We learned, however, the hard way that subprime mortgage lending created opaque legal constructions and produced securities that did not deliver on one of their core

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167. *Id.* at "Risk Factors—Prepayment Premiums May Affect a Borrower's Ability to Sell a Mortgaged Property or Refinance a Mortgage Loan, and May Affect the Yields on Your Securities."

168. *Id.* at "Risk Factors—The Securities May Not Be Suitable Investments."

functions—a manageable allocation of risk. Because the markets were not provided with efficient information that allowed effective pricing, the markets became self-destructive.

### C. AN AVALANCHE OF LETTERS<sup>169</sup>

*“All the ills we face. . . can be traced back to illiteracy.”*<sup>170</sup>

As we look at the legal documents along the risk chain, we are buried by an avalanche of letters. Certainly, this is a not un-common feature of Western civilization since the invention of the printing press by Johannes Gutenberg around 1450. Based on the idea “of the ‘autonomy’ of law”<sup>171</sup> it, however, washed away pictures and reached gigantic proportions with Martin Luther’s “*sola scriptura*,”<sup>172</sup> when it was extended far beyond its religious meaning:

[T]he fact that looking at law as a constant element may easily induce a distorted and limited vision of the external world. . . . Starting from rules may lead to select perceptions, and therefore events themselves, according to a predefined model which often happens to correspond to an individual’s personal views about what rules mean. Factual interpretation, in short, may easily become normatively bound. As a result, lawyers often tend to have a preselected and simplified vision of the social landscape that surrounds them, all the more so because law, by its own inner logic, ‘dychotomizes reality’. . . on the basis of the ‘lawful-unlawful’ (Recht-Unrecht) discrimination code.<sup>173</sup>

Letters became the most reliable instruments for ordering.<sup>174</sup> Certainly, law requires that we ignore certain complexities of life;<sup>175</sup> but in law, as always, the amount makes the poison: “*Iura scripta sunt vigilantibus*.”<sup>176</sup> (“The laws are written for the weary.”)—But how watchful does one have to be to hold one’s own? In addition, how are we keeping a statistical balance, when the line stretches further and further between parties with different social and educational experiences?

169. Leslie Eaton & Amir Efrati, *Lawyers Will Be Lawyers, Dumping More on Juries Than They Can Process*, WALL ST. J., Nov. 6, 2008, at A16, available at <http://online.wsj.com/article/SB122593285676003505.html>.

170. Judy Keen, *After Hudson’s Death, Chicago Vows to Fight Rising Murder Rate*, USA TODAY, Oct. 29, 2008, at 3A, available at [http://www.usatoday.com/news/nation/2008-10-28-hudson\\_N.htm](http://www.usatoday.com/news/nation/2008-10-28-hudson_N.htm).

171. Vincenzo Ferrari, *Law and Society Studies and Legal Education*, 55 J. LEGAL EDUC. 495, 497 (2005).

172. See generally Diarmaid MacCulloch, *The Reformation: A History* (2004). For the power of the word in the Protestant legal culture see Bernard Hibbitts, *The Revision of Law: The Pictorial Turn in American Legal Culture*, <http://faculty.law.pitt.edu/hibbitts/pictor.htm>.

173. Vincenzo Ferrari, *Law and Society Studies and Legal Education*, 55 J. LEGAL EDUC. 495, 497 (2005).

174. Naglee v. Ingersoll, 7 Pa. 185 (1847) (“The black letter of the law.”).

175. Amnon Reichman, *Law, Literature, and Empathy: Between Withholding and Reserving Judgment*, 56 J. LEGAL EDUC. 296, 307 (2006).

176. Cf. Corpus Iuris Civilis, Digesta 41. 10,24.

Before the onset of the subprime mortgage crisis, everything appeared to be well documented. But, in fact, the reality of risks had disappeared behind a veil of *precisely lettered* optimism. The sheer amount of detail oriented legal letters covered-up the complexity of the many transactions involved in the subprime mortgage fiasco, individually and cumulatively. Risks were not managed along the links, they hid behind walls of paper created by each link. Inexperienced, low income borrowers did not understand what they were getting into. At the same time, investors relied on more than the protection offered by legal disclosure; they relied on prudent underwriting practices, backed by Wall Street's good will as financial adviser, not just seller. And, finally, it seems like Wall Street did not know what it was getting into either. The attempt to realize an American dream therefore turned full circle against those in whose favor it was made.

#### D. UP TO REALITY—AGAIN

*"Our duty is 'reality, reality, reality' however difficult to achieve."*<sup>177</sup>

Recent decisions by Massachusetts courts<sup>178</sup> seem to indicate a return to reality when discussing home loans with four characteristics: (i) adjustable rates, (ii) teaser rates, (iii) debt-to-income ratios exceeding fifty percent, and (iv) loan-to-value ratios of 100% or certain prepayment penalties. The Commonwealth of Massachusetts Appeals Court saw the situation as follows:<sup>179</sup>

[I]t is to be expected that the borrower will not be able to meet the scheduled payments once the 'teaser' rate expires at the close of the introductory period [i.e. the Initial Period], and the loan will be 'doomed to foreclosure' unless the borrower is able to refinance the loan at or around the close of the introductory period; and where loans also have the fourth characteristic [i.e. a loan-to-value ratios of 100% or prepayment penalty], the borrower has no realistic prospect of being able to refinance should housing prices decline.

The lower Commonwealth of Massachusetts Superior Court had concluded:<sup>180</sup>

Given the fluctuations in the housing market and the inherent uncertainties as to how that market will fluctuate over time, this Court finds that it is unfair for a lender to issue a home mortgage loan secured by the borrower's principal dwelling that the lender reasonably expects will fall into default once the introductory period ends

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177. Bernhard Grossfeld, *Global Financial Statements/Local Enterprise Valuation*, J. CORP. L. 337, 362 (2004).

178. Commonwealth v. Fremont Inv. & Loan and Fremont Gen. Corp., *supra* note 85; Massachusetts v. Fremont Investment & Loan & another, Mass. Appeals Ct., Civil Action No. 08-J-118 (May 2, 2008), available at <http://www.goodwinprocter.com/~media/F661C77BEC2E46A1BBE14B286BAE48DB.ashx>.

179. Commonwealth v. Fremont Inv. & Loan & another, *supra* note 178, at 3.

180. Commonwealth v. Fremont Inv. & Loan and Fremont Gen. Corp., *supra* note 85, at 18 *et seq.*

unless the fair market value of the home has increased at the close of the introductory period. To issue a home mortgage loan whose success relies on the hope that the fair market value of the home will increase during the introductory period is as unfair as issuing a home mortgage loan whose success depends on the hope that the borrower's income will increase during the same period.

The Washington *Summit on Financial Markets and the World Economy* in November 2008 added the following insight to the picture:<sup>181</sup>

[M]arket participants sought higher yields without an adequate appreciation of the risks and failed to exercise proper due diligence. At the same time, weak underwriting standards, unsound risk management practices, increasingly complex and opaque financial products, and consequent excessive leverage combined to create vulnerabilities in the system.

The Leaders of the Group of Twenty therefore put "Strengthening Transparency and Accountability" on top of their "common principles for reform."<sup>182</sup> Immediate Actions to be taken by March 31, 2009 were to:<sup>183</sup>

- . . . address weaknesses in accounting and disclosure standards for off-balance sheet vehicles[;]
- . . . enhance the required disclosure of complex financial instruments by firms to market participants[;] and
- . . . [enhance] the governance of the international accounting standard setting body.

Accounting as a legal instrument finally got to the front page.<sup>184</sup>

## VI. MACRO-JUSTICE<sup>185</sup>

The story told in this article offers a sad, but nevertheless great, story for legal edification. It shows, how we lawyers abandoned the legal analysis of economics, while not noticing how compartmentalized legal regulation became. The law disconnected from economic results, as we failed to consider the macro-economic consequences of individual acts. At the same time, the economic analysis of the law did not take notice of these concerning developments. For the mathematical models used to predict the markets proved insufficient,<sup>186</sup> when reality exposed their inherent

181. See Press Release, Office of the Press Secretary, Declaration of the Summit on Financial Markets and the World Economy 1 (Nov. 15, 2008), [http://www.fsforum.org/press/pr\\_151108.pdf](http://www.fsforum.org/press/pr_151108.pdf).

182. *Id.* at 3.

183. *Id.* at 6.

184. See generally Bernhard Grossfeld, *Global Accounting: A Challenge for Lawyers*, *supra* note 30, at 143; Bernhard Grossfeld, *International Financial Reporting Standards: European Corporate Governance* in *O DIREITO DO BALANÇO E AS NORMAS INTERNACIONAIS DE RELATO FINANCEIRO* 11 (J. L. Sadanha Sanchez ed., 2006).

185. Alfred Conard, *Macrojustice: A Systematic Approach to Conflict Resolution*, 5 GA. L. REV. 415, 420 (1971); Cf. H. Peyton Young, *EQUITY—THEORY AND PRACTICE* 6 *et seq.* (1995).

186. See White, *supra* note 16.

weakness. They cannot “cope with illogical and uneconomic factors.”<sup>187</sup>

Securitization created investment products of international reach that separated financing from the location of the financed object—though “*location, location, location*” has always been the common and almost hackneyed phrase in real estate. It was able to do so, by giving ABS a *letteral* appearance through a series of complex, highly regulated transactions, accounted for under generally accepted principles. The persons involved in these transactions, however, did not apply the standards of statistical reasoning and were therefore unaware of their macro-economic impact. A legal analysis of economics would have detected this development, because it takes into account that markets depend on systems of law as it uses such systems as cognitive models. The legal analysis of economics thereby binds the language of economics to the grammar of a value system and limits the power of self-interest according to the moral order of a society. It sets pragmatic standards for economic interests that are typically not derailed by illogical economic factors.

We lawyers need to re-embrace this analysis. This does not mean that we need to conduct extended business studies,<sup>188</sup> we must simply be fact oriented and observe how our work influences economic reality. This is more than words, words, words. But it is not more difficult than it is for economists to analyze the law, and that could be an important lesson from the subprime mortgage crisis!

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187. L. Gordon Crovitz, *The 1% Panic*, WALL ST. J., Oct. 6, 2008, at 17A.

188. Roberta Romano, *After the Revolution in Corporate Law* (Yale Law & Economics Research Paper No. 323, 2005) available at <http://ssrn.com/abstract=824050>; see also Bernhard Grossfeld, *Comparative Accounting*, 28 TEX. INT'L. L. J. 233 (1993).



# Articles



